



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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MEMORANDUM FOR ASSOCIATE AREA COUNSEL, CHICAGO

FROM: Special Counsel, CC:INTL

SUBJECT: Dividends subject to withholding tax under I.R.C. §§ 1441 and 1442

LEGEND

Corp 1 =

FX =

Activity J =

Activity K =

Activity L =

Country A =

This Chief Counsel Advice responds to your memorandum dated March 13, 2002. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

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## ISSUE

Whether dividend payments by Corp 1 to FX are exempt from tax under I.R.C. § 892 and therefore not subject to withholding, during the taxable years at issue, pursuant to I.R.C. §§ 1441 and 1442.

## CONCLUSION

Based on the facts presented we do not agree that either Corp 1 or FX can be shown to be a “controlled commercial entity” within the meaning of I.R.C. § 892(a)(2)(B). Accordingly, we do not support the position taken that the dividends paid by Corp 1 to FX are not exempt from tax under I.R.C. § 892 and therefore subject to withholding under I.R.C. §§ 1441 and 1442.

## FACTS

The principal business of Corp 1, a domestic corporation, is conducting Activity J. It also earns income from Activity K, at least some of which is associated with Activity J, or adjacent to areas in which Activity J is conducted. The stock of Corp 1 is owned 50% by a domestic corporation and 50% by FX, a separate juridical entity, organized in Country A.

In Country A, FX conducts Activity L. The exact scope and character of activities authorized and necessary as part of FX’s conduct of Activity L is uncertain. In addition, the relationship of FX to the government of Country A or any governmental agency or subdivision is unknown. However, it is known that during the years under examination FX was owned ultimately by the government of Country A.

During examination of Corp 1, it was learned that Corp 1 paid dividends to FX, but did not withhold taxes on those dividend payments. Corp 1 claimed that FX was a foreign government and therefore the dividend payments were exempt from federal income tax under I.R.C. § 892 and not subject to withholding pursuant to Temp. Treas. Reg. § 1.892-7T(e). The examiners disagreed, and proposed a deficiency for failing to withhold tax on the dividend payments, contending that Corp 1 was a “controlled commercial entity” within the meaning of I.R.C. § 892(a)(2)(B) because (1) FX held a 50 percent interest in Corp 1 and (2) Corp 1 was engaged in commercial activities by reason of its conduct of Activity J, and in the alternative, by reason of Corp 1’s conduct of Activity K.

## LAW AND DISCUSSION

The determination of whether the dividends received by FX qualify for exemption from tax under section 892 requires analyzing the status of both Corp 1 and FX, the shareholder. Under I.R.C. § 892(a)(2)(A)(ii), the section 892 tax exemption does

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not apply to income received by or from a “controlled commercial entity.” (Emphasis added). Accordingly, if either Corp 1 or FX constitutes a controlled commercial entity, the Corp 1 dividend distributions received by FX will not qualify for exemption from tax and will be subject to withholding under I.R.C. §§ 1441 and 1442. Based on the available information, neither Corp 1 nor FX appear to meet the definition of a controlled commercial entity within the meaning of section 892(a)(2)(B).

Although the government of Country A directly or indirectly held a 50% interest in Corp 1, it is questionable whether it was engaged in commercial activity. First, its principal business, Activity J, is one of the governmental functions specifically enumerated within the governmental functions provision of Temp. Treas. Reg. § 1.892-4T(c)(4). Although the reference in the regulations could be subject to interpretation, on these facts, it is unlikely a court would find in favor of the Service if this case were litigated. Second, while Corp 1’s conduct of Activity K would generally be characterized as commercial, there is some risk that a court might find that the close relationship of Activity K to Activity J casts doubt on that characterization in this case. Accordingly, based on the facts presented, we do not recommend the field pursue an argument that Corp 1 is engaged in commercial activity on the basis of either Activity J or Activity K.

While it appears that FX may likely constitute a “controlled entity” of a foreign sovereign within the meaning of Temp. Treas. Reg. § 1.892-2T(a)(3) and thus a foreign government for purposes of I.R.C. § 892, more precise information would be needed before making such a determination. To the extent that FX were determined to be a controlled entity, denial of the exemption would also require establishing that FX was engaged in commercial activity as defined in Temp. Treas. Reg. § 1.892-4T(b). The information currently available is insufficient to determine that FX constituted a controlled entity and was engaged in commercial activities so as to not be entitled to exemption from tax with respect to the dividend payments it received under I.R.C. § 892(a)(2)(A)(ii). Absent significant factual development focused on FX’s foreign government status (i.e., controlled entity vs. integral part) and the activities it conducts, we do not agree that FX can be said to be a “controlled commercial entity” within the meaning of section 892(a)(2)(B).

Please call (202) 622-3810 if you have any further questions.

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(International)